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In The

Supreme Court of the United States

October Term, 1975

GERALD F. PADUANO and CAROLINE PADUANO, ROCCO M. CAPPUCCILLI and DOROTHY CAPPUCCILLI, PETER L. CAPPUCCILLI and GRACE A. CAPPUCCILLI,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No.: 75-1381

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners ask that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

Opinions Below

The opinion of the Court of Appeals has not been reported as of this date. The opinion of the Tax Court (Appendix, pp. A5ff; R.* 75-84) is reported officially at 34 T.C.M. 368 (1975)

* "R" refers to the portion of the printed record in the Court of Appeals entitled "APPENDIX". "Ex." refers to the Exhibit Volume from the APPENDIX.

Jurisdiction

The decision of the Court of Appeals was rendered on January 12, 1976, and the judgment was entered on the same day (Appendix, pp. A12, A13). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Question Presented for Review

Whether the Commissioner has authority under §482 of the Internal Revenue Code to impute interest income on related party loans, whether or not the obligee is on an accrual or a cash basis, where said loans bear less than an arm's-length rate of interest, and where the related obligor's financial situation is such that payment of the imputed interest could not reasonably be expected.

Statute and Regulations Involved

Section 482 of the Internal Revenue Code of 1954, 26 U.S.C. §482 is the applicable statute involved and provides as follows:

§482. Allocations of income and deductions among taxpayers

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The regulations involved are §§1.482-1 and 1.482-2(a) of the Income Tax Regulations (26 C.F.R. §§1.482-1 and 1.482-2(a)), pertinent portions of which are reprinted in the Appendix, pp. A1-A4.

Statement of the Case

Relevant to the questions presented, the material facts in this case have been stipulated, or are undisputed or are found as follows:

During the years in issue, taxpayers Gerald Paduano, Rocco Cappuccilli and Peter Cappuccilli were equal partners in a partnership known as Cappuccilli, Cappuccilli and Paduano (hereinafter referred to as CCP). Each of the taxpayers were also equal shareholders in Stonehedge Development Corporation (Stonehedge), Seneca Sewerage Corporation (Seneca) and Cappy's Real Estate, Inc. (Cappy); CCP was principally engaged in the real estate business (R.62). As a result of land sales, during the period involved, CCP held purchase money mortgage notes from Stonehedge amounting to $1,122,850. and a purchase money mortgage note from Seneca amounting to $25,000. Stonehedge and Seneca had also assumed existing first mortgages on land that they purchased from CCP (Joint Exhibits 33-AG-39AM). Also during 1967 through 1969 CCP made numerous advances to Cappy and Stonehedge (R. 64-69). Relative to all of the obligations involved, only the $25,000. mortgage note from Seneca, and the $81,000. mortgage note from Stonehedge bore interest (R. 65.78).

The mortgage notes due to CCP from Stonehedge were to be paid over a 10 to 12 year period from the proceeds from sales of developed lots (approximately 100 per year) by Stonehedge (R. 103). Although interest payments were made by Stonehedge and Seneca to other creditors during this period, no interest was paid to CCP during this period (R. 65, 79).

Zoning restrictions, a tight money market, a New York State appropriation action and a general decline in the real estate business during the years involved, all contributed to a complete termination of the development plan (R. 104, 105). As a result, there was no cash flow to Stonehedge and it was unable to pay its obligations to CCP (R. 122). The financial condition of the

debtor corporations was so critical that they could not borrow funds from banks and CCP had to advance funds so that non-related first mortgagees and other creditors could be paid. Funds also were advanced by CCP to the three related corporations so that they could continue operations (R. 122, 123). In March, 1972 CCP foreclosed on its mortgages against Stonehedge and Seneca (R. 107).

Pertinent financial information of these companies, based on federal income tax returns stipulated in evidence, is as follows:

	Taxable Income	Cash Balance	Current Liabilities
STONEHEDGE			
December 31, 1967	$ 2,835.09	$ 1,948.79	$ 115,879.12
December 31, 1968	*(57,780.03)	3,099.85	1,409,507.10
December 31, 1969	(113,177.10)	1,640.44	1,414,056.67
(Joint Exhibits 25-Y, 26-Z, 27-AA)			
SENECA			
June 30, 1968	—0—	$ 400.41	$ 174,443.73
June 30, 1969	—0—	300.04	149,428.29
(Joint Exhibits 30-AD, 31-AE)			
CAPPY			
December 31, 1967	—0—	$13,271.84	$ 127,078.94
(Joint Exhibit 32-AF)			

(The extremely poor cash position in relation to current liabilities is readily noted.)

Because interest was not paid on the mortgage notes and loans by the corporate obligors to CCP, the Commissioner, under Section 482 of the Internal Revenue Code, imputed interest to CCP for the years 1967, 1968 and 1969, at a rate of five percent (5%) per annum (R. 81). Correlative adjustments

*Brackets indicate losses.

for interest deductions were allowed by the Commissioner to the three corporate obligors (R. 81). As a result of the interest income imputed to CCP each partner's distributive share of income increased, and likewise their income tax liability. Total deficiencies for the three partners amount to $83,429.44 (R. 72-74). The three partners and their wives (by virtue of their filing joint income tax returns with their husbands) petitioned the Tax Court for redetermination (R. 76). The cases were consolidated for trial and have remained consolidated on appeal.

The Tax Court in a memorandum opinion (Appendix, pp. A5,ff, R. 75-84) followed the case of *B. Forman Company v. Commissioner of Internal Revenue*, 453 F.2d 1144 (C.A. 2, 1972) affirming in part and reversing in part 54 Tax Ct. 913 (1970), certiorari denied 407 U.S. 934, rehearing denied 409 U.S. 899 (1972), which ruled for the Commissioner on this point. Although the Tax Court did not (nor does it now) agree with *Forman, supra*, it was bound to follow it under the rule laid down in *Jack E. Golsen*, (Tax Court on cases squarely in point is bound by Circuit Court decision in which it sits) 54 Tax Ct. 742 (1970) aff'd 445 F.2d 985 (C.A. 10, 1971) certiorari denied 404 U.S. 940 (1971). The United States Circuit Court of Appeals for the Second Circuit (no opinion has been rendered to date) affirmed the United States Tax Court (Appendix pp. A12, A13).

REASON FOR GRANTING THE WRIT

In the Application of Section 482 of the Internal Revenue Code to Loans Between Related* Taxpayers at Less Than an Arm's Length Rate of Interest, the United States Tax Court has Applied Three Different Rules (tracing concept); Four United States Circuit Courts of Appeal have Applied a Contrary Rule; (consistent with each other) but the Rule Applied by the Four Circuit Courts of Appeal, as It Presently Stands, is Contrary to Established Rules of Taxation (Even as Applied in Their Own Courts), and Discriminates Against Related Parties. Application of These Various Rules, Causes Inequities in Tax Administration and Confusion of the Tax Law And Should be Authoritatively Settled by This Court.

Summary of Problem

A review on writ of certiorari is warranted in this case because there is a difference of opinion between the United States Tax Court and the United States Circuit Court of Appeals for the Second, Fifth, Eighth and Ninth Circuits, on the issue of whether the Commissioner of Internal Revenue has authority under Section 482 of the Internal Revenue Code and the regulations thereunder to impute interest income on loans between related parties, where such loans bear less than an arm's length rate of interest. The Tax Court has consistently held that the borrower must have gross income and that all or part of the gross income was produced by the funds borrowed (a tracing concept). The Circuit Courts of Appeal have held that there is no requirement under Section 482, of the Internal Revenue Code, and the regulations thereunder, that the related borrower have gross income during the years in issue, and that the

*As used throughout this petition, the term "related" is intended to encompass the "two or more organizations . . . owned or controlled . . ." etc. referred to in Section 482 of the Internal Revenue Code.

Commissioner is authorized to impute interest income to the related lender, notwithstanding the lack of gross income of the borrower.

Petitioners are of the opinion that the Tax Court's tracing concept is wrong, and further that the rule applied by the Circuit Courts of Appeal is also erroneous as the rule now stands. Related parties should be treated as non-related parties not only in applying Section 482, but also in limiting the application of that section to instances where the related obligor's financial condition is such that interest could reasonably be expected to be paid by the related obligor to the obligee. For example, if "A" and "B" are non-related parties and on January 1, "A" loans "B" $1,000,000. at five percent (5%) to be paid in two years, and "A" is under accrual method of accounting, under the law, at the end of the first year "A" would be required to accrue interest income; but, if "B" became bankrupt during the first year "A" would not be required to accrue interest income. However, if "A" and "B" were related, as the law now stands in the four Circuit Courts of Appeal, "A" would be charged with an interest income allocation.

Certiorari was denied by this Court in the case of *B. Forman Company, Inc. v. Commissioner of Internal Revenue, supra,* which involved the questions of control and the "creation of income" concept under Section 482 and the regulations thereunder. Petitioners agree with the "control" interpretation as defined by the Second Circuit Court of Appeals in *Forman, supra,* but disagree with the broad *Forman* rule that the Commissioner may allocate interest income to the related lender where less than an arm's length rate of interest was charged. The question of the related debtor's financial ability to pay interest was not an issue in *Forman, supra* (nor in the decisions of the other three Circuit Courts of Appeal, which will be discussed later). Since the *Forman* case, *supra,* there have been seven Tax Court cases, one District Court case and five Circuit Court of Appeals cases involving the Commissioner's right to impute

interest income on loans between related parties. The law on this issue is presently in a state of confusion and more litigation would follow, unless this Court rules and finally settles the matter.

Argument

Under Section 482, of the Internal Revenue Code the Commissioner has authority to allocate income, expenses, and credits between controlled parties, when such allocation is deemed necessary in order to clearly reflect the income of the parties and to prevent the avoidance of taxes. Under the Treasury regulations, where loans are made between controlled parties at less than an arm's length rate of interest, the Commissioner has authority to make an allocation to the lender of a proper rate of interest. Regulations §1-482-2(a)(1)(2).

In *B. Forman Company, Inc. v. Commissioner of Internal Revenue, supra*, one of the issues involved a Section 482 allocation of interest relative to non-interest bearing loans made by two corporations which each owned 50% of a corporation, they formed to build a shopping center. The questions before the United States Tax Court were: was there control (under §482) by the two corporations over the debtor, and secondly if the necessary control existed could the Commissioner of Internal Revenue allocate or impute interest income to the related obligee. The Tax Court found that the necessary control did not exist; therefore, the question of allocation of interest income was not decided. On appeal to the Second Circuit Court of Appeals, that Court found that the necessary control existed and that the Commissioner had authority under Section 482 and the regulations thereunder to allocate interest income to the related lender, without a showing that there was gross income realized by the debtor attributable to the borrowed funds.

Prior to the *Kerry* case (*Kerry Investment Co. v. Commissioner of Internal Revenue*, 500 F.2d 108 (C.A. 9, 1974) affirming and reversing the Tax Court, 58 Tax Ct. 479 (1972)) the United States Tax Court consistently held that as to transactions between related parties the Commissioner was not authorized under Section 482 (and the regulations thereunder) to "create" income (where none existed), then allocate said "created" income among the related parties. Likewise, if loans were made between related parties on an interest free basis (or at less than an arm's length), the Commissioner could not impute interest income to the lender to reflect an arm's length rate of interest.

See *Smith—Bridgman & Co.*, 16 Tax Ct. 287 (1951) Acq. 1951-1.C.B 3; where the borrowing corporation used loan proceeds from its parent to pay outstanding bonds, but no interest was charged to the borrower. The Tax Court held that the Commissioner could not impute interest income; true also in *PPG, Industries Inc. v. Commissioner*, 55 Tax Ct. 928 (1970); *Combs Lumber Co. v. Commissioner*, 41, B.T.A. 339 (1940). Even where an interest bearing note was given to the related obligee, the Tax Court held the Commissioner could not charge interest if the parties agreed that no interest would be charged until some future time. *Society Brand Clothes, Inc. v. Commissioner*, 18 Tax Ct. 304 (1952); *Atchinson Topeka & Santa Fe Railway Co. v. Commissioner*, 36 Tax Ct. 584 (1961).

In *Huber Homes, Inc. v. Commissioner*, 55 Tax Ct. 598 (1971) the Tax Court opened the door for the Commissioner to use a different tactic, i.e. assert that part of the gross income of the related obligor should be allocated to the obligee on the theory that the funds which were borrowed at less than an arm's length interest rate generated income for the related obligor; therefore, part or all of said income should be allocated to the obligee in order to properly reflect income of the related parties.

In *Huber Homes, supra*, the parent sold homes at cost to its subsidiary. The subsidiary rented the homes, and the Commissioner attempted to charge the parent company with income on the difference between the fair market value of the homes and

the cost to the subsidiary. The Tax Court held against Commissioner stating at page 607:

> the Commissioner does not here contend that any . . . of (the subsidiary's) gross rental income was not earned by it or that any portion of its income should be allocated to (the parent).

And on page 610 the Tax Court used language which was the basis of its subsequent decision in *Kerry* (discussed *infra*):

> But if as a consequence of . . . the use or consumption by the transferee (of goods or services transferred to it at less than arm's length prices) income is realized within the controlled group, an entirely different question would be presented.

Citing *Smith—Bridgman & Co., supra, PPG Industries, supra* and *Huber Homes, Inc., supra*, the Tax Court stated in *Kahler v. Commissioner*, 486 F.2d 1 (C.A. 8, 1973) reversing and remanding Tax Court, 58 Tax Ct. 496 (1972) at page 506:

> The Tax Court has consistently held that a prerequisite to the Commissioner's allocation authority under Section 482 is the existence of an item of income deduction, credit or allowance which had its genesis in the particular transaction between the related parties."

And at page 507:

> Where the controlled group, for example, has realized no income from the particular transaction within the group, we have undeviatingly held Section 482 to be inapposite.

The *Kerry* case, *supra*, (which was reviewed by the entire Tax Court) involved interest free loans between related parties. The Commissioner used two arguments under Section 482 in the Tax Court: interest income should be imputed to the related obligee, and gross income should be allocated from the obligor to the obligee. Of the various loans involved, some were traced to income producing assets some to non-income producing assets and some could not be traced at all. The Tax Court held that the

petitioner had the burden of proving that the interest free loans did not produce income, accordingly the Tax Court held for Commissioner's allocation on all loans except for the loans which were traced to non-income producing assets.

Because of the pertinent language, substantial extracts are quoted from the concurring opinion of Tax Court Judge Irwin, and the dissenting opinion of Judge Featherston. Note the concurring opinion of Judge Irwin at pp. 493, 494:

> In both *Kerry* and *Kahler*, we affirmed this Court's previous position in this area: namely, that the Commissioner cannot utilize Section 482 to "create" income solely by imposing arm's length dealing on related parties where his only allegation is that there were interest-free advances between the parties. In *Kerry*, however, we are going one step further because respondent not only attempted to allocate non-existent interest income *per se* as in *Kahler*, he in addition sought to allocate income generated by the Kerry subsidiary from the *use and consumption* of interest free funds.
>
> Consistent with *Smith—Bridgman & Co.*, 16 Tax Ct. 287 (1951) Acq. 1951 — 1 C.B. 3; *PPG Industries, Inc.*, 55 Tax Ct. 928 (1970); and *Huber Homes, Inc.*, 55 Tax Ct. 598 (1971) the former type of allocation is again rejected in both *Kerry* and *Kahler*. The latter type of allocation, however, that of income generated from the use and consumption of the interest free loans is approved in *Kerry* because it is an allocation of income from one related party to another and is not an allocation of non-existent interest. *Kerry* is the first case before this Court in which we have been faced with the application of §482 to an improper deflection of income caused by the use or consumption of interest-free advances.

Judge Featherston who dissented, disagreed with the tracing concept as being inconsistent with the language of Section 482 and its implementing regulations. At page 495 he states:

As I read Section 482 and these regulations, the applicability of that section does not depend upon the realization of pretax profits from a particular non-arm's length transaction or, in the case of borrowed funds, the use to which they are placed. The section refers to "gross income" and "deductions" and does not specify the source from which they may be derived . . .

I fail to see how the tracing concept, which involves an analysis of the borrowing corporation's use of the advanced funds and the financial results of such use during the tax years, can be squared with these regulations. Moreover, I think the concept gives birth to a mischievous rule. Apart from the endless disputes it will engender as to whether particular uses of the borrowed funds (e.g. to pay overhead, capital expense, long term investments, etc) produced income during the tax years, it places a premium on accounting sophistication and lays a trap for the unwary. By the simple expedient of investing the particular borrowed dollars in non-productive assets, section 482 can be circumvented even though such investment releases other funds for income-producing uses. On the other hand, if the borrower is not aware of this limitation which the majority is writing into the regulations and mingles the borrowed dollars with other capital, Section 482 may be applied.

On appeal, the Circuit Court of Appeals for the Ninth Circuit reversed the Tax Court in *Kerry* on the tracing concept, holding that the Commissioner could allocate interest income to the related obligee regardless whether the funds borrowed, at less than an arm's length rate of interest, produced or generated income for the related obligor.

In *Kahler, supra*, the Tax Court maintained its tracing concept developed in *Kerry, supra*, but was reversed by the Eighth Circuit Court of Appeals, again on the theory that it was not necessary to show that the borrower earned income on the interest free loans.

The Fifth Circuit Court of Appeals in *Fitzgerald Motor Co. v. Commissioner of Internal Revenue*, 508 F.2d 1096 (C.A. 5, 1975) affirmed Tax Court 60 Tax Ct. 957 (1973) but on a different principle. The Tax Court held for Commissioner on the tracing doctrine. The Appeals Court held that tracing was not necessary, stating that the Tax Court's theory required two elements; did borrower have gross income during the year in question, and was this income derived from using the borrowed funds. The Appeals Court said that this test is needlessly complicated and the requirement that the debtor have gross income is not required under section 482 of the regulations; citing Reg 1.482-2 (a)(1).

In a slightly different fact situation involving related party loans, the Eighth Circuit Court of Appeals upheld the government in a situation where a parent company borrowed money at a rate of 5.55 per cent and loaned the funds to a group of subsidiaries under an agreement whereby the parent would receive the same rate of interest — but from the group as a whole. Some individual subsidiaries paid more than 5.55 and some (who were losing money) paid no interest at all. The federal district court held that the Commissioner could not allocate interest income to the parent from the subsidiaries which paid no interest. On appeal, the district court was reversed. *Liberty Loan Corporation v. United States*, 498 F.2d 225 (C.A. 8, 1974) reversing and remanding 359 F. Supp. 158 (D.C.E.D. Miss. 1973).

In one recent Tax Court case the Court followed *Forman, supra*, because the *Golsen, supra*, rule was applied; *Cayuaga Service, Inc.*, 34 T.C.M. 18 (1975) and in another recent case the Court held for the Commissioner under the *Kerry, supra*, tracing theory, *Club View Corporation*, 34 T.C.M. 922 (1975). In the latter case at page 924 the Tax Court in referring to the divergence of views which had been developed on this issue (Citing *Forman, Fitzgerald, Kerry and Kahler, supra*) stated:

> For petitioners to prevail under this Court's existing case law they would have to prove 'that the proceeds of each particular loan were not used by the borrower to produce gross income' during the taxable years in issue. *Fitzgerald Motor Co., supra*, at 963. As petitioners have not presented any evidence on this point, they cannot prevail and respondent's determination must be sustained. Because we have sustained respondent under this Court's existing case law, we need not reconsider his argument that he is empowered to impute interest income irrespective of whether the borrowed funds produce gross income.

Although petitioners are of the opinion that the Tax Court is wrong on its tracing theory, (for the reasons given in dissenting opinion of Judge Featherston in the *Kerry* case, *supra*) nevertheless, the rule laid down by the Circuit Courts of Appeal is too broad, i.e. The Commissioner is authorized under Section 482 and the regulations to impute interest income regardless whether the funds borrowed produced income. It should be noted that with respect to all of the Circuit Court cases, *Forman, Kerry, Kahler, Fitzgerald, Liberty Loan, supra*, and *Paduano* (no citation), no restriction is placed upon the Commissioner's right to allocate interest income to the related party, in the event collection of said interest is unlikely because of the related debtor's financial condition. Also, throughout these cases, the courts, in upholding the Commissioner, have emphasized the fact that related parties should deal with each other at arm's length, and that economic realities should be observed. But should not this same rule also be applied to related parties when relief from taxation is sought?

The Courts have recognized that in non-related taxpayer situations, if collection of interest is not reasonably expected, an accrual basis obligee is not required to report interest income. *Corn Exchange Bank v. United States*, 37 F.2d 34 (C.A. 2, 1930); *American Cigar Co. v. Commissioner*, 66 F.2d 425 (C.A. 2, 1933); *Barker v. Magruder*, 95 F.2d 122 (C. Ct. D.D.

1937); *Greer-Robbin Co. v. Commissioner*, 119 F.2d 92, 93 (C.A. 9, 1941).

In *Corn Exchange Bank, supra*, (involving an accrual basis taxpayer), the Court said at page 34:

> When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonably expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when in point of fact it never was received.

The example given by Judge Augustus N. Hand in his concurring opinion at page 35 is relevant:

> If "A" loaned $100,000. to "B" and the latter was a hopeless insolvent, but "A" did not know it, can it be thought that "A" would create taxable income by mistakenly entering interest upon the loan upon his books? What the government is permitted by the constitution to tax is real not supposed income.

But suppose in that example "A" and "B" were related, should the Commissioner have authority to impute interest income regardless of "B's" insolvent position? The answer should be no, otherwise the law would discriminate against related parties who make loans to each other. However, the Commissioner in the *Pitchford's Inc. v. Commissioner*, 34 T.C.M. 384 (1975) must have realized the inequity of such an application of the law. *Pitchford, supra*, involved transactions between related taxpayers, and the petitioner used the accrual method of accounting. *The Commissioner conceded that he could not allocate interest income to petitioner under section 482 if the obligor's financial condition was so shaky that there was no reasonable expectancy of collection.* The Tax Court held that the obligor was not economically sound during the tax years involved; therefore, the Commissioner could not allocate interest income to the controlling obligee (taxpayer).

However, the Tax Court stated at page 386:

> We express no views on the question whether allocation of interest income under section 482 is indeed precluded where there would not have been a reasonable expectancy of collection of such interest. For purposes of this case only, we accept respondent's concession on this point.

Notwithstanding the Tax Court's remarks, petitioners are of the opinion that the concession by the Commissioner makes good sense. *His concession squares with the treatment that in loan transactions related parties should be treated as non-related parties, not only for purposes of imputing additional interest income, but also in determining whether there is a reasonable expectancy in the collection of such additional interest income.* In essence, the imputation of interest income under §482 should be tempered with the ruling in the *Corn Exchange Bank* case; i.e. interest income should not be imposed when the debtor's financial condition would make collection remote.

If as between related taxpayers no interest should be imputed to *an accrual basis taxpayer* (obligee) because of the obligor's shaky financial situation, the same rule should also apply to related taxpayers if the obligee happens to be *on the cash basis.* The accounting method (cash or accrual) employed by the obligee has no bearing on the obligor's financial ability to pay. Thus if an obligor has no funds with which to pay an accrual basis obligee, the same would be true as to the obligor's ability to pay a cash-basis obligee. Any other rule would be discriminatory against cash basis taxpayers who make loans to related parties.

Although, the cases holding, that an accrual basis taxpayer is not required to accrue interest income where collection is not reasonably expected, (*Corn Exchange, Greer-Robbin, Barker, America Cigar, supra*) were decided prior to the promulgation of regulations under section 482, (1968), the Commissioner has apparently accepted this rule more recently in the *Pitchford,* case, *supra,* by virtue of his concession.

In *Commissioner v. First Security Bank of Utah,* 405 U.S. 394 (1972) the Commissioner attempted to charge various banks with commissions on insurance policies which the banks were responsible for initiating but, because it was against the banking law for banks to engage in insurance business, or to act as insurance agents, the banks referred the policies to an independent company without charging a commission. The independent company and the banks were part of a related group of companies. The Commissioner was unsuccessful in attempting to allocate part of the commission income to the banks.

While *First Security Bank of Utah* concerned the allocation of prohibitive income, parts of the decision are relevant to our case. Justice Powell in stating that the question was "whether there was a shifting or distorting of the Banks' true net income . . ." (pp. 400-401) said at page 403:

> We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. *In cases dealing with the concept of income it has been assumed that the person to whom the income was attributed could have received it.* The underlying assumption always has been that *in order to be taxed for income a taxpayer must have complete dominion over it.* (Emphasis added)

See also *L. E. Shunk Latex Products, Inc. v. Commissioner,* 18 Tax Ct. 940, 961 (1952) cited by the Supreme Court in *First Security Bank of Utah, supra,* where the Tax Court held that the Commissioner "had no authority to attribute to petitioners income which they could not have received." In the *Corn Exchange Bank* case, *supra,* the creditor had a right to the interest income, but because collection was not reasonably expected, a tax was not imposed.

Under Treasury Regulations §1.482-1(d)(2) whenever the Commissioner makes an adjustment to a taxpayer's income, he

is required to make an appropriate correlative adjustment to the other related party. It would appear from the regulation that if "A" makes an interest free loan to "B", a related party, and the Commissioner charges "A" with $50,000. of interest income, then from an accounting viewpoint the entries for "A" and "B" would be as follows:

On A's Books:

Debit: Interest Receivable from B	$50,000.	
Credit: Interest Income		$50,000.

On B's Books:

Debit: Interest Expense	$50,000.	
Credit: Interest Payable ~~to~~ A		$50,000.

Thus, "A" would be entitled to $50,000. from "B" as a result of the "correlative adjustments" required under the aforementioned regulations. But if "B", for the year in issue becomes bankrupt, then, under the present rule of the Circuit Courts of Appeal, "A" would have to pay an income tax on the interest income although it could not possibly collect the interest due from "B". Yet if "A" and "B" were not related, "A" would not have to pay a tax, *Corn Exchange Bank*, (Second Circuit) *American Cigar Co.*, and *Barker* and *Greer-Robbin Co.*, (Ninth Circuit), *supra*. Thus, the Second and Ninth Circuit agree that nonrelated parties (on an accrual basis) would not have to pay a tax on interest income if the possibility of collection is remote. Yet, according to the rule set forth in *Forman*, (Second Circuit) and *Kerry*, (Ninth Circuit) the Commissioner would be authorized to impute interest income in related party loans which bear less than an arm's length rate of interest without limitation as to the related obligee's possibility of collecting the imputed interest from the related obligor. In effect, these two Circuit Courts would be contradicting their own established rule of taxation regarding interest income, or they would be discriminating against related party loans, unless their present rule is limited.

According to the Regulations:

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. Treasury Regulations §1.482-1(b).

Thus, on the question of collectability of interest income there is no justification for applying one standard to non-related parties, and a different standard to related parties.

In fact, the Second Circuit Court in *Forman* established the principle (followed by the Fifth, Eighth and Ninth Circuits) that related parties should deal with each other at arm's length; i.e. as non-related parties would. Then, why should not the Court follow its own rule and apply the "nonrelated" standard to related parties when it involves the collection of the imputed interest income. In effect, the Second Circuit applied the nonrelated standard to impute interest income to the related obligee *in the instant case*, but would not apply the same standard to determine the collectability of the interest income which was imputed.

The facts in the instant case clearly show that because of the problem which arose concerning development the related obligors could not develop the lots, as planned, consequently there was no cash flow with which to pay the obligations, (including the imputed interest to CCP). In fact, *Stonehedge*, *Seneca* and *Cappy* could not borrow from banks and CCP had to advance funds to them so that they could pay third party creditors in order to avoid foreclosure on first mortgages and to keep these companies in operation. Finally, because payments were not forthcoming, CCP had to foreclose on its mortgages against Stonehedge and Seneca.

Except for the instant case, in the other Circuit Courts of Appeal cases ruling on section 482 (on the issue of loans be-

tween related parties at less than an arm's length rate of interest); namely, *Forman*, *Kerry*, *Kahler*, *Fitzgerald* and *Liberty Loan*, *supra*, the question of the related obligor's financial ability to pay interest was not raised. Nevertheless, it is respectfully submitted that based on the cases previously cited (*Pitchford's*, *L. E. Shunk Latex Products, Inc.*, *First Security Bank of Utah*, *Corn Exchange Bank*, *supra*) an equitable and simple rule to be applied in section 482 cases involving loans between related parties would be:

> Where less than an arm's length rate of interest is charged on related party loans, the Commissioner has authority to apply section 482 to reflect a proper interest rate, regardless whether the related obligee is on the cash or accrual basis of accounting, *but only* if there is a reasonable expectation that interest could be collected by the obligee from the related obligor.

This rule would avoid the unwieldly "tracing" test applied by the United States Tax Court, and also, would avoid the discrimination against related parties which is inherent in the present expansive rule applied by the Circuit Courts of Appeal for the Second, Fifth, Eighth and Ninth Circuits.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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_____, 1976.

APPENDIX

RELEVANT TREASURY REGULATIONS

INCOME TAX REGULATIONS:

Sec. 1.482-1

(a) (3) The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. . . .

* * *

(6) The term 'true taxable income' means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length.

(b) Scope and purpose. (1) the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard

to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * *

(d) Method of allocation. (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. . . .

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as 'primary' adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. . . . If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of

determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year . . . .

* * *

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in §1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period . . . . if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

Sec. 1.482-2

Determination of taxable income in specific situations. — (a) Loans or advances — (1) In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

(2) Arm's length interest rate. For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the

time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. . . . If the creditor was not regularly engaged in the business of making loans or advances of the same general type as the loan or advance in question to unrelated parties, the arm's length rate for purposes of this paragraph shall be . . .

(i) The rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest,

(ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest, . . .

(3) Loans or advances to which subparagraph (1) applies. Subparagraph (1) of this paragraph applies to all forms of bona fide indebtedness and includes:

(i) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

OPINION OF THE UNITED STATES TAX COURT

T. C. Memo. 1975-69

UNITED STATES TAX COURT

GERALD F. PADUANO AND CAROLINE PADUANO, ET AL.,[1] Petitioners *vs.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 7103-72, 7168-72, 7169-72. Filed March 20, 1975.

Victor Chini, for the petitioners.

John D. Steele, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge:* Respondent has determined the following deficiencies in the Federal income tax of the petitioners:

Petitioners	Year	Deficiency
Gerald F. and	1967	$11,061.91
Caroline Paduano	1968	8,881.62
	1969	8,824.21
Rocco M. and	1967	$10,553.54
Dorothy Cappuccilli	1968	9,217.04
	1969	7,921.75
Peter L. and	1967	$10,094.08
Grace A. Cappuccilli	1968	8,753.64
	1969	8,121.65

[1] Cases of the following petitioners are consolidated herewith: Rocco M. Cappuccilli and Dorothy Cappuccilli, Docket No. 7168-72; and Peter L. Cappuccilli and Grace A. Cappuccilli, Docket No. 7169-72.

We are to decide if respondent properly imputed interest income to petitioners pursuant to section 482, Internal Revenue Code of 1954, as amended. [2]

FINDINGS OF FACT

Gerald F. and Caroline Paduano, Rocco M. and Dorothy Cappuccilli, and Peter L. and Grace A. Cappuccilli, husbands and wives, filed joint Federal income tax returns for the years in issue with the district director of internal revenue, Buffalo, New York, and were residents of Syracuse, New York, when the petitions herein were filed.[3]

In 1954 petitioners formed a partnership styled "Cappuccilli, Cappuccilli and Paduano" (CCP), in which each had a one-third interest and which engaged principally in the business of renting and selling realty. Each of petitioners also held a one-third stock interest in: Stonehedge Development Corporation (Stonehedge), organized on April 8, 1953; Seneca Sewerage Corporation (Seneca), organized on April 1, 1961; and Cappy's Real Estate, Inc. (Cappy), organized on September 3, 1958.

In the period February 22, 1961 — January 3, 1962, CCP acquired five contiguous farms, known collectively as Seneca Knolls, at a total cost of $320,083.[4] On January 10, 1962,

[2]All section references are to the Internal Revenue Code of 1954, as amended.

[3]Hereinafter "petitioners" shall refer to Gerald Paduano, Rocco Cappuccilli and Peter Cappuccilli, collectively.

[4]

Farm	Date of Purchase	Purchase Price
Walter	2/22/61	$ 64,065
Commane	10/20/61	71,830
Green	10/26/61	34,788
Patterson	11/24/61	22,400
Higgins	1/ 3/62	127,000

CCP conveyed Seneca Knolls to Stonehedge in consideration of: a cash payment in the amount of $3,430; the assumption of mortgage obligations totalling $275,170; and a note in the amount of $1,075,000, bearing no interest, secured by a purchase money mortgage, and providing for the payment of $75,000 on January 10, 1964, and of $100,000 on January 10 of each of the ten succeeding years.

Henderson Farm, lying adjacent to Seneca Knolls, was purchased by CCP on March 8, 1960, for $125,460. The farm was sold to Stonehedge on February 20, 1961, in consideration of: a cash payment of $27,894.86; the assumption of mortgage obligations totalling $107,605.14; and a note in the amount of $81,000, bearing interest at an annual rate of six percent, secured by a purchase money mortgage, and providing for payment to be made in equal installments on the first and second anniversaries of the sale.

CCP purchased Preston Farm from Stonehedge on April 15, 1961, for $22,500. Petitioners intended that a sewerage treatment plant be built at Preston Farm to service Seneca Knolls and Henderson Farm. Pursuant to that design they caused CCP to sell one-half of the Preston Farm to Seneca on April 16, 1961, in consideration of: a cash payment of $5,000; the assumption of mortgage obligations of $10,000; and a note in the amount of $25,000, bearing interest at the rate of six percent per annum, secured by a purchase money mortgage, and providing for payment in full on April 15, 1966.[5]

Petitioners anticipated that Seneca Knolls and Henderson Farm would be subdivided into lots, the sales of which would provide Stonehedge with sufficient funds to discharge the obligations which it incurred in acquiring the realty; but owing

[5]The note afforded Seneca a limited right of prepayment but provided for no abatement in purchase price in the event that right were exercised.

to circumstances which need not be recounted here, the development of those properties could not proceed as planned. Consequently, Stonehedge was unable to reduce the principal amount of its indebtedness to CCP in compliance with the terms of its several obligations. These obligations were not wholly satisfied until March 14, 1972, pursuant to an action in foreclosure initiated by CCP.[6]

Seneca did not discharge the obligation which it incurred in purchasing one-half of Preston Farm until 1973.

CCP waived compliance with the interest obligations incurred by Stonehedge and Seneca in purchasing Henderson Farm and one-half of Preston Farm, although both of these corporations paid interest to others of their creditors while the mortgage obligations to CCP remained outstanding.

Aside from the mortgage loans, CCP made advances to Stonehedge and Cappy to enable them to defray expenses necessary to their continuing in operation. Certain of these loans, in respect of which interest was neither charged nor paid, were outstanding during the years in issue.

[6]Prior to January 1, 1967, Stonehedge reduced the principal amount of its mortgage obligations to CCP by $33,150. It made no further payments of principal prior to the foreclosure.

OPINION

Where one member of a group of commonly controlled entities becomes indebted to another but is charged no interest, respondent may allocate interest to the creditor under section 482,[7] would interest have been charged under like circumstances in an arm's length transaction. *B. Forman Company* v. *Commissioner*, 453 F.2d 1144 (C.A. 2, 1972), affirm-

[7]
SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS

In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Income Tax Regs. adopted pursuant to sec. 482 provide in pertinent part:

Sec. 1.482-1(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. ***

Sec. 1.482-1(a)(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income *** which would have resulted to the controlled taxpayer, had it in the conduct of its affairs *** dealt with the other member or members of the group at arm's length. ***

Sec. 1.482-2(a) *Loans or advances*—(1) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

ing in part and reversing in part 54 T.C. 913 (1970), certiorari denied 407 U.S. 934 (1972).[8] Pursuant to his authority under section 482, respondent has imputed interest income to CCP at the rate of five percent per annum on the loans to Stonehedge, Seneca and Cappy outstanding during the years in issue.[9]

Petitioners have acknowledged that no interest was charged on the nonmortgage loans but have failed to demonstrate that a party dealing with Stonehedge and Cappy at arm's length would have done the same. Accordingly, we hold that respondent properly imputed interest income to CCP in respect of the nonmortgage loans.

Petitioners have also failed to demonstrate that a party dealing with Stonehedge at arm's length would not have charged interest on the obligation of $1,075,000 incurred by Stonehedge in purchasing Seneca Knolls. And had CCP been dealing with Stonehedge and Seneca at arm's length, it would likely have insisted that they honor their commitments to pay interest annually on the obligations which they incurred in purchasing Henderson Farm and one-half of Preston Farm, respectively;

[8]This Court does not espouse the interpretation of sec. 482 set forth in *B. Forman Company* v. *Commissioner*, 453 F.2d 1144 (C.A. 2, 1972), affirming in part and reversing in part 54 T.C. 913 (1970), certiorari denied 407 U.S. 934 (1972). See *Kerry Investment Co.*, 58 T.C. 479 (1972), affirmed in part and reversed in part 500 F.2d 108 (C.A. 9, 1974); *Kahler Corp.* 58 T.C. 496 (1972), reversed 486 F.2d 1 (C.A. 8, 1973); *Fitzgerald Motor Co.*, 60 T.C. 957 (1973), affd. ——F.2d —— (C.A. 5, 1975). We shall, however, apply it in this instance. See *Jack E. Golsen*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (C.A. 10, 1971), certiorari denied 404 U.S. 940 (1971).

[9]Petitioners concede that if interest is properly imputable to CCP under the circumstances obtaining herein, the rate utilized by respondent is appropriate.

Respondent has allowed Stonehedge, Seneca and Cappy additional interest deductions for the years in issue in amounts equal to the interest income which he has allocated to CCP under sec. 482.

for both corporations were paying interest to others of their creditors while the aforesaid two obligations were outstanding. CCP, however, failed to enforce these commitments, apparently for no other reason than that it was commonly controlled with Stonehedge and Seneca.

Petitioners maintain that while ostensibly no interest was paid on the mortgage loans, the price for which the realty was sold included an element of interest. This contention is properly to be sustained only upon a demonstration that in each instance the realty was intentionally sold at a price exceeding its fair market value by the amount of interest that would have accrued at a definite rate over the term of the contract of sale. *Elliott Paint & Varnish Co.*, 44 B.T.A. 241 (1941); *Kingsford Co.*, 41 T.C. 646 (1964).

Petitioners have purported to show that Seneca Knolls, Henderson Farm and one-half of Preston Farm were each sold for an amount sufficiently in excess of fair market value to include interest accruable over a 12-year period at 8.5 percent, 7.5 percent and 12 percent, respectively. In our judgment, this evidence does not substantiate petitioners' contention. Of the three contracts of sale, only one provided for payment over a 12-year period, the other two providing for payment over periods of two and five years.[10] Seneca was authorized to prepay its obligation to CCP; had it availed itself of that privilege, however, there would have been no abatement of the purchase price under the terms of the contract of sale. Petitioners, furthermore, have not undertaken to explain in terms of their contention why CCP might have charged differing rates of interest with respect to each of the mortgage obligations; or why two of the contracts of sale were made expressly to provide for

[10]Clearly it is irrelevant to the matter in issue that neither of the latter two obligations was in fact timely paid.

the payment of interest over and above the sale price at the annual rate of six percent. We are therefore convinced that in setting the price at which each piece of mortgaged realty was sold by CCP, petitioners did not intend that the price include unstated interest.[11] Accordingly,

Decision will be entered for the respondent.

JUDGMENT OF THE COURT OF APPEALS

United States Court of Appeals

Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twelfth day of January one thousand nine hundred and seventy-six.

Present:

HON. IRVING R. KAUFMAN
Chief Judge

HON. WILLIAM H. TIMBERS

HON. ELLSWORTH A. VAN GRAAFEILAND
Circuit Judges

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[11] See by way of contrast *Estate of Betty Berry*, 43 T.C. 723 (1965), affd. per curiam 372 F.2d 476 (C.A. 6, 1967), certiorari denied 389 U.S. 834 (1967).

Gerald F. Paduano and Caroline Paduano, Rocco M. Cappuccilli and Dorothy Cappuccilli, Peter L. Cappuccilli and Grace A. Cappuccilli,

Petitioners-Appellants,

vs.

Commissioner of Internal Revenue,

Respondent-Appellee.

75-4138

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed with costs to be taxed against the petitioners-appellants.

A. DANIEL FUSARO,
Clerk

By VINCENT A. CARLIN,
Chief Deputy Clerk